Industry Developments and Alerts

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Insurance industry developments - 2003/04; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Insurance Industry Developments — 2003/04

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of insurance companies with an overview of recent economic, industry, regulatory and professional developments that may affect the engagements and audits they perform.

This online publication is an Other Auditing Publication as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Julie Gould, CPA
Technical Manager
Accounting and Auditing Publications

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John Adimari, Partner Re
Keith Bell, Travelers Property Casualty Corp.
Darryl Briley, KPMG LLP
Richard Burness, Deloitte & Touche LLP
Jean Connolly, Pricewaterhouse Coopers LLP
Aimi Daniel, Deloitte & Touche LLP
Donald Doran, Pricewaterhouse Coopers LLP
Maureen Downie, KPMG LLP
Kathleen N. Enright, Allstate Insurance Company
Danielle Fandrey, Deloitte & Touche LLP
Ed Hardy, Deloitte & Touche LLP
Michael E. Harrington, Ernst & Young LLP
Ben Korbly, Pricewaterhouse Coopers LLP
Joanne Lauterbach, Ernst & Young LLP
Elaine Lehnert, Veris Consulting
William Lowry, Capital Decision Sciences LLC
Susan McGrath, Veris Consulting
Mark Parkin, Deloitte & Touche LLP
Ricky S. Propper, American Express Tax and Business Services, Inc.
Mary Saslow, PricewaterhouseCoopers LLP
Margaret C. Spencer, American Express Tax and Business Services, Inc.
Deborah H. Whitmore, Ernst & Young LLP
Shelley Zimmerman, Liberty Mutual Insurance Company

Insurance Industry Developments—2003/04

How This Alert Helps You

This Audit Risk Alert helps you plan and perform your insurance audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

If you understand what is happening in the insurance industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2003/04* (product no. 022333kk).

Industry and Economic Developments

See the AICPA general *Audit Risk Alert—2003/04* for a discussion of the U.S. economic and business environment.

Property and Casualty Sector

There has been ongoing improvement in the industry's financial results driven by pricing trends. Most insurers are successfully increasing rates in the personal and commercial lines. However, lower interest rates are generating lower investment income on insurers' portfolios. There is considerable range with respect to reserve adequacy, particularly for certain commercial coverages such as commercial automobile, worker's compensation, and medical malpractice. During 2003, many companies made significant additions to asbestos and environmental claims reserves as increased claim activity was sparked by publicity and court rulings.

Claims under directors and officers liability insurance could become more extensive with the passage of the Sarbanes-Oxley Act of 2002, as there may be increased exposure for corporate lawsuits. Since the September 11 attacks, there have been a number of new entrants into the reinsurance market, providing new capital in excess of $6 billion. Reinsurers have been deemphasizing proportional coverages in favor of excess of loss coverages. This change in the type of reinsurance coverage may result in primary insurers retaining greater risk, thereby subjecting surplus to greater volatility.

Sales of insurance via the Internet continue to be slow. For example, Internet sales of personal automobile insurance are still less than 1 percent of total personal automobile sales. However, the Internet is becoming a more frequent interface for companies' communications with their agents, policyholders, and claimants.

Auto Insurance

The state of New Jersey continues to undergo dramatic changes. In 2002, a number of major insurers announced their intention to withdraw from New Jersey because of burdensome regulations. The largest insurer received approval to reduce its book of business by approximately 200,000 (4,000 per month for 24 months) cars. This business will be absorbed by other insurers. In order to address profitability issues, New Jersey passed an auto reform bill that includes provisions which increase target reforms, expedite rate approval process, phase out the Take All Comers Law, decrease the withdrawal period for insurance enterprises that wish to leave the market, allow for territorial revisions, and disband the Unsatisfied Claim and Judgment Fund (UCJF). New Jersey is one of three states to have an "excess profits" regulation (New York and Florida are the others). New Jersey changed the calculation of excess profits from a paid loss to an incurred loss basis, changed the look-back period from three to seven years, and added an exemption for companies that exhibit growth and reinvestment of capital in the New Jersey market place. The effect of the change is uncertain.

Claims fraud has been and continues to be a problem for insurers in certain large states, most recently in New York and Florida. In particular, higher personal injury protection coverage loss ratios have resulted from fraud and abuse through unfounded lawsuits and increased medical reviews. Auto maintenance and repair costs have been accelerating, and pricing restrictions in a number of states make sustained profitability difficult to achieve. Residual markets in New York, New Jersey, Pennsylvania, and Texas have grown in recent years.

Homeowners' Insurance

The cost of insuring a home has continued to rise significantly in 2003. A. M. Best reported that the homeowner line of business was profitable for only one year during the last decade. The central region of the country has exhibited extreme volatility in homeowner results.

In August 2001, a district court in the state of Texas awarded a single homeowner $32 million as a result of an insurance company's alleged improper investigation and remediation of water damages that resulted in mold infestation of the home.

Primarily as a result of this award, mold became the focus of media, legal, and political hype. Since 2001, insurance carriers have been forced to take actions to combat this environment in order to preserve their profitability. Their actions include rate increases and coverage restrictions. Although the state of Texas, unlike most other states, has a specific homeowner's policy form that does not allow coverage for water damage to be restricted to "sudden and accidental" losses, insurers have also taken actions in other states, fearing that this could also become a national issue. Throughout 2002, many insurers found that these actions did not mitigate the claims losses they received in Texas; consequently, they either exited the homeowner's insurance market in the state or greatly restricted their writings.

In order to continue to provide reasonably priced homeowner's coverage, in August 2003, the Texas Department of Insurance ordered most of the top 32 insurance companies to lower their rates by a mandated percentage. To date, many of these insurers have accepted this mandate or come to a mutual agreement on a revised mandate. Others have appealed or sued the state in order to preserve rates that they say are adequate to pay covered losses.

Life and Health Sector

In 2003, the life and health insurance industry continued to experience challenges caused by volatile equity and interest rate markets. Sales trends of annuities varied widely among carriers as they redesigned products to change guaranty features.

The U.S. life insurance industry is generally well capitalized with good asset quality. However, some key issues affecting life insurers include:

- Low investment yields caused by the sustained low interest rate environment have put pressure on earnings.
- The downgrading of insurers in 2002 and early 2003 reduced industry confidence; some rating agencies have looked negatively upon the industry.
- Investment losses from credit deterioration persist, despite a slowing of credit deterioration as compared to 2002. Writedowns and sales of investments, both equity and fixed income, especially in the telecommunications and energy sector, have affected results. See the section entitled "Declines in the Value of Securities" of this Alert for a discussion of other than temporary impairment.
- Some companies continued to experience the acceleration of amortization of deferred acquisition costs (DAC) for products accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.* Early 2003 declines in equity markets have resulted in exposures for accelerated amortization of DAC, particularly where the variable annuity business is concerned. Recent publicity has revealed that a number of different

treatments are being used to address differences between long-term assumptions regarding market returns and actual experience. Equity market returns are particularly relevant to the amortization of variable annuity DAC, since investment return (a key component of the estimation of future gross profits) is based on the valuation of the separate account assets. See the "Deferred Acquisition Costs" section of this Alert for further DAC considerations.

Minimum Guaranteed Death Benefits

Variable annuity products that contain minimum guaranteed death benefits (MGDBs) or guaranteed minimum income benefits (GMIBs) have two main issues to consider:

1. Companies may experience general account charges for the payout of these benefits (upon either death or annuitization, as applicable) when the market value of the separate account assets is not sufficient to support the level of benefit payment.
2. Generally accepted accounting principles (GAAP) and statutory accounting may require insurers to establish reserves for variable annuity guarantees on these products, thereby placing strain on capital strength.

AICPA Statement of Position (SOP) 03-01, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and Separate Accounts*, contains guidance for accounting for MGDBs and GMIBs.

Health Insurance Portability and Accountability Act Compliance

The Health Insurance Portability and Accountability Act (HIPAA) of 1996 will be a significant initiative for health plans, health care providers, and clearinghouses that process health information electronically. Auditors should be aware that most covered entities were required to comply with HIPAA standards by April 2003 (April 2004 for small companies that write less than $5 million in receipts).

HIPAA was adopted to improve the efficiency and effectiveness of the health care system by standardizing the electronic transmission of certain administrative and financial transactions. Significant cost reductions are projected due to the utilization of standard formats, codes, and identifiers for electronic claims. Many health care organizations may have replaced or substantially changed their current systems and processes to comply with HIPAA regulations.

The convergence to electronic data interchange will require significant changes to how security and privacy are addressed. As a result, HIPAA also mandates security and privacy protection standards for individually identifiable health information that is stored, processed, or transmitted. Security standards require comprehensive, formal, written procedures for protecting all patient-identifiable information stored or transmitted by any electronic system. Privacy regulations cover patient-identifiable health information in any other form that is or has been in electronic form. Patients must give their written, uncoerced, and revocable permission to use health information for purposes other than treatment, payment, health care operations, and specified exceptions (public health, oversight, law enforcement). Records of disclosures must be kept, and patients have the right to challenge and correct their health information.

International Accounting News

In July 2003, the International Accounting Standards Board (IASB) published for comment Exposure Draft 5, *Insurance Contracts*. The comment letter deadline was October 31, 2003. The exposure draft proposes guidance for insurance companies that will be expected to comply with International Financial Reporting Standards (IFRSs) in 2005. At present, there is no IFRS that addresses insurance contracts, and insurance contracts are excluded from some existing standards that would otherwise be relevant.

Exposure Draft 5 marks only the first phase of the IASB's insurance project. The overall objectives of Phase I are:

1. Make limited improvements to accounting practices for insurance contracts without requiring major changes that may need to be reversed when the IASB completes Phase II.
2. Require an entity issuing insurance contracts (an insurer) to disclose information about those contracts.

The IASB intends to finalize the Phase I standard on insurance contracts during the first quarter 2004.

During Phase II of the project, the IASB will address broader conceptual and practical issues related to insurance accounting. The IASB intends to resume its research and consultation on Phase II. It will consider whether the approach being explored can be developed into a standard that is consistent with the IASB Framework and is workable in practice.

Privacy and Security Update

Nearly four years after passage, the privacy and security provisions contained in Title V of the Gramm-Leach-Bliley Act (GLBA) remain the cornerstone of federal efforts to regulate the handling of nonpublic personal financial information by federal and state regulated financial services institutions. Title V of the GLBA addresses the issues of how a financial services institution may use its customers' nonpublic personal information, including the providing of required notice and disclosures, and imposes upon each institution an affirmative obligation to protect its customers' information from unauthorized disclosure to internal, as well as external, sources. Under the GLBA's functional regulation approach, primary responsibility for regulation and enforcement of insurance industry compliance with GLBA's privacy and security requirements was delegated to the states.

Shortly after the GLBA was signed into law, state insurance regulators, working through the National Association of Insurance Commissioners (NAIC), commenced the development of a privacy regulation consistent with Congress's stated goals and objectives. As permitted by language in the GLBA, permitting states may impose additional or more stringent protections, the model developed by the NAIC includes personal health as well as financial information. The NAIC's Privacy of Consumer Financial and Health Information Model Regulation was adopted by the NAIC in September 2000.

According to the NAIC:

- All 50 states and the District of Columbia have taken steps to put privacy protections in place that meet GLBA standards; 49 states and the District of Columbia have taken final action. Discussions about uniform interpretation are ongoing.
- NAIC members adopted the Standards for Safeguarding Customer Information Model Regulation in April 2002. The model regulation establishes standards for insurers to meet the confidentiality and security requirements of Section 501 of GLBA. Approximately 14 states have taken action to promulgate this model regulation.
- The Privacy Notice Content Subgroup was formed to draft sample language for insurers to use so privacy notices are understandable to consumers, while retaining operational uniformity and compliance with the requirements of the NAIC model privacy regulation that are critical to industry. The subgroup has issued a report and considered comments from regulators and interested parties.

Entities should be aware of the state privacy regulations and other emerging regulations to which the entity will be subject.

Accounting and Auditing—General

Variable Interest Entities

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which clarifies the application of Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from others.

FASB Interpretation No. 46 introduces a new category of entities referred to as variable interest entities (VIEs). The population of VIEs consists of more entities than those previously considered special-purpose entities (SPEs). Certain types of partnerships, joint ventures, and other types of legal structures may also qualify as VIEs. A VIE is defined as any legal entity for which either:

1. Its equity investment at risk is less than its expected losses (e.g. its equity at risk is not sufficient to support the financing of the entities operations), or
2. The group of equity investors at risk does not have a controlling financial interest.

The group of equity investors at risk has a controlling financial interest if they satisfy all of the following conditions:

1. Possess the direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights.
2. Are obligated to absorb the expected losses of the entity if they occur.
3. Have the right to receive the expected residual returns of the entity if they occur.

If an entity is not considered a VIE, then, generally, it would be considered a voting interest entity unless it qualifies for one of the various scope exemptions. Consolidation of voting interest entities is governed by the guidance in ARB 51 or FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

Consolidation of VIEs is based on which party absorbs the majority of expected losses or expected returns of the entity through a variable interest(s). This model differs significantly from the consolidation model for voting interest entities, which bases the consolidation decision on control. Under the latter model, generally, the party possessing more than 50 percent of the voting interest would generally be required to consolidate.

Variable interests in an entity include items such as contractual relationships, ownership interests in the form of equity or certificates, certain types of derivatives, debt instruments, service agreements, or other interests in an entity that expose the holder to the potential risks and rewards of a VIE. If a company determines it is involved in a VIE and its involvement represents a significant variable interest, that company is required to determine whether its relationship with the entity endows them with a majority of the entity's expected losses or expected returns.

The determination of the expected loss or expected return is achieved by analyzing the probability of potential variations in the results of the VIE's activities. A party that receives the majority of expected losses or expected returns is referred to as the primary beneficiary of a VIE. If there is a party that absorbs the majority of the expected losses of a VIE, and another party will receive a majority of that entity's expected residual returns, the enterprise absorbing a majority of the losses, would consolidate that entity. If no party is obligated to absorb the majority of the expected losses of the VIE, the party who is entitled to the majority of the expected returns (including certain fees) is required to consolidate.

FASB Interpretation No. 46 may present a wide range of implications for insurance and reinsurance companies based on the various types of activities and investments companies have entered into with entities that likely fall under the definition of a VIE. Companies might have a variety of involvements with VIEs that require consideration regarding the potential for the company to be a primary beneficiary, and therefore, the consolidator of a VIE. The following are certain types of transactions that may be impacted by FASB Interpretation No. 46:

- Catastrophe reinsurance structures
- Reinsurance pools and associations
- Segregated/protected cells
- Asset securitization transactions (e.g., collateralized debt obligations)
- Structured notes (e.g., certain principal notes, equity-linked, or credit-linked notes)

- Trust preferred-like structures
- Certain investments in real estate partnerships and joint ventures
- Certain types of leasing transactions

In adopting FASB Interpretation No. 46, companies will not only be required to evaluate the potential consolidation of VIEs, they will also need to evaluate the potential for deconsolidating activities. Prior to FASB Interpretation No. 46, companies may have consolidated certain entities based on interpretations of applicable guidance. For example, a company that issued preferred securities out of a trust typically had consolidated the trust based on a conclusion that the company was the sponsor of the vehicle or the "owner" of the trust. Under FASB Interpretation No. 46, some of these structures may no longer be consolidated by the "sponsor" based on the analysis of who is the primary beneficiary of the vehicle.

For VIEs created after January 31, 2003, and for VIEs in which an enterprise obtains an interest after that date, FASB Interpretation No. 46 applies in the first fiscal year or interim period beginning after June 15, 2003. This Interpretation applies to public enterprises as of the beginning of the applicable interim or annual period, and it applies to nonpublic enterprises as of the end of the applicable annual period. It may be applied prospectively with a cumulative-effect adjustment as of the date of initial application, or by restating previous years with a cumulative-effect adjustment as of the beginning of the first year restated.

For VIEs created before February 1, 2003, the effective date for public companies with interest in VIEs meeting specified conditions would be for the first year or interim period ending after December 15, 2003. Early application is encouraged. The FASB continues to evaluate the effect of this standard on various industries and has drafted a new exposure draft, *Consolidation of Variable Interest Entities—A Modification of FASB Interpretation No. 46*, as well as several proposed Financial Statement of Positions which may impact how companies apply FASB Interpretation No. 46. See the FASB Web site at www.fasb.org for additional specific information regarding additional implementation and practice developments.

Reinsurance Arrangements

Reinsurance accounting and reporting—in particular, the question of what constitutes an acceptable transfer of risk—continues to be an important issue requiring careful analysis. The Securities and Exchange Commission (SEC) and state insurance departments have closely scrutinized the accounting and reporting practices of insurance companies with respect to reinsurance transactions.

FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, and Emerging Issues Task Force (EITF) Discussion Topic D-34, *Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*, continues to be the primary source of guidance used to determine whether a contract transfers risk and meets the conditions for reinsurance accounting. However, new accounting standards continue to have complex implications for transactions involving reinsurance arrangements. In addition to evaluating the appropriateness of transfer of risk on reinsurance arrangements, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, may necessitate counterparties to reinsurance arrangements placed in certain types of structures, (i.e., catastrophe bond structures) to consider potential consolidation of the activities of such structures.

The FASB has continued its evaluation of certain types of reinsurance contracts for potential derivatives and FASB Statement No. 133 Implementation Issue B36 (B36), *Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments*, represents the latest focus of attention for insurance enterprises. During the initial implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, many companies acknowledged the existence of an embedded derivative in modified coinsurance (modco) and coinsurance with funds withheld arrangements, and other contracts with similar provisions. However, they believed that the embedded derivative arising from the pass-through of investment results on a debt (bonds and mortgage loans) portfolio was "clearly and closely related" to the debt host contract and, therefore, exempt from bifurcation requirements.

In 2002, numerous discussions among and public comments by the AICPA, SEC, and FASB focused on this issue, and in April 2003, the FASB released B36. The FASB has clarified that an instrument that incorporates credit risk exposures that are either unrelated or only partially related to the creditworthiness of that instrument's obligor has an embedded derivative that is not considered "clearly and closely related" to the economic characteristics and risks of the host contract. B36 will have a dramatic effect on the way both ceding and assuming companies account for modified coinsurance and coinsurance with funds withheld reinsurance contracts and similar arrangements that include an arrangement for passing a return that is linked to the performance of investments held by the ceding company to the reinsurer.

The issue is actually broader than just modified coinsurance and coinsurance with funds withheld reinsurance agreements. The scope would encompass any receivable or payable where the interest is determined by reference to an actual pool of assets (unless the pool were comprised entirely of risk-free debt securities and/or real estate) or determined by any index other than a "pure" interest rate index. This would include any contracts where experience refund or commutation provisions consider the actual investment performance of a referenced pool of assets. In addition to modco and coinsurance with funds withheld agreements, companies will need to consider whether reinsurance contracts that have experience refund provisions contain embedded derivatives, because of use of actual investment performance or non-interest-only indices in the calculation.

Although it is the presence of third-party credit risk in a modified coinsurance or coinsurance with funds withheld contract that is triggering the need for both parties to bifurcate an embedded derivative, B36 deliberately never describes the embedded derivative as either a "credit derivative" or a "total return swap," because the FASB has acknowledged that each contract may have unique features.

Auditors of GAAP basis financial statements, where the conditions described above exist generally should consider reviewing the company's supporting documentation related to the implementation of B36 to be sure that they understand and agree with management's implementation methodology and to ensure that the embedded derivative is appropriately accounted for in accordance with B36.

EITF Issue No. 93-6, *Accounting for Multiple Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, and EITF Issue No. 93-14, *Accounting for Multiple Year Retrospectively Rated Contracts by Insurance Enterprises and Other Enterprises,* and EITF Topic D-35, *FASB Staff Views on Issue No. 93-6*, represent guidance addressing issues that may be present in reinsurance transactions. These EITF issues address contractual features that create future rights and obligations as a result of past events and therefore require certain accruals to be made in the financial statements. As products become more advanced and complex, careful consideration is required to determine whether the contracts are being accounted for appropriately based on a complete understanding of the facts and circumstances. Alternative risk transfer products and finite risk covers usually present complex issues with respect to evaluating the contracts for risk transfer under FASB Statement No. 113.

SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk,* should be used to determine the appropriate method of accounting for contracts that do not meet the requirements for reinsurance accounting under FASB Statement No. 113. SOP 98-7 outlines the appropriate accounting for contracts based on one of the following categories:

1. Contracts that transfer only significant timing risk

2. Contracts that transfer only significant underwriting risk, contracts that transfer neither significant timing nor underwriting risk

3. Contracts that have an indeterminate risk

Significant Industry Losses and Lower Investment Returns

After steady erosion throughout most of the 1990s, reinsurance rates have increased across all lines of business compared to the beginning of this decade. The rate increases experienced post September 11 appear to be leveling off in certain lines, however, the outlook for other lines continue to present the potential for rate increases. Eroding surplus levels and poor underwriting results have caused some reinsurers to reduce writings or exit certain lines of coverage, such as directors and officers coverage.

An increase in rates causes reinsurance consumers to question the amount of coverage they obtain and the type of reinsurance they purchase. If the cost of coverage increases, reinsurance purchasers will attempt to control their risk management costs by obtaining less coverage, purchasing higher layers, or increasing their retention. Products referred to as alternative risk transferring vehicles or finite risk transactions might be presented to companies as alternatives to their traditional programs that have become more costly. Although these products may take many forms, they usually contain terms that require careful consideration with respect to determining whether the transfer of risk is adequate to be accounted for as reinsurance. If the contracts fail to meet the conditions for reinsurance accounting, financial statement preparers need to determine whether the contracts require deposit accounting or require fair value accounting.

As insurers continue to evaluate the losses reported on the significant catastrophes that have occurred and the impact organizations have experienced from weak investment returns, careful consideration should be given by ceding enterprises as to the financial strength of its reinsurers. The reinsurer's strength is one indicator to support the collectibility of ceded loss reserves and other reinsurance balances receivable. A significant number of insurers and reinsurers have experienced reductions of surplus, as a result of losses and economic conditions, leading to heightened attention from regulators and rating agencies. The existence of these conditions should compel companies to closely monitor the collectiblity of their reinsurance balances, including the reasonableness of their allowance for uncollectible reinsurance.

Additional Pronouncements

In addition to Implementation Issue No. B36 discussing certain embedded derivative issues in reinsurance arrangements, other interpretations of FASB Statement No. 133 offer guidance on evaluating the appropriate accounting for certain types of reinsurance arrangements. Implementation Issue No. B26, *Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts*, identified certain types of insurance contracts that could be considered to have derivative type features. The Interpretation defines policies with dual-triggers as agreements for which the payment of a claim is triggered by the occurrence of two events (that is, the occurrence of both an insurable event and changes in a separate preidentified variable). Certain types of dual trigger contracts would be subject to the provisions of FASB Statement No. 133 if more than the occurrence of an insured event was a barrier to the policyholder being availed a reimbursement under a contract. The FASB has determined all of the following conditions must be met in order for a contract, possessing dual triggers, to meet the scope exception and to be accounted for as a traditional insurance contract:

- Benefits and claims are paid only if an identifiable insurable event occurs.
- The amount of the payment is limited to the amount of the policyholder's incurred insured loss.
- The contract does not involve essentially assured amounts of cash flows based on the insurable event, such that recoveries under the contract are more likely determined by the referenced variable.

In other words, if the occurrence of the insurable event is highly probable and the amount the insured would most likely receive is altered by the variable, the contract or a portion of it is subject to the provisions of FASB Statement No. 133.

The FASB provided implementation guidance with respect to guarantee type contracts in Implementation Issue No. B27, *Dual-Trigger Financial Guarantee Contracts*. The interpretation states a similar conclusion to the aforementioned issue that contracts that pay for declines in value are subject to FASB Statement No. 133; however, if the payments are based on an insured loss that must be a precondition of the contract, (i.e. default), the contract would meet the scope exception for traditional insurance.

Purchase Accounting

FASB Statement No. 141, *Business Combinations*, supersedes the guidance contained in Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, with the most significant change being the elimination of the pooling of interests method. Currently, the FASB is working on a follow-up business combination project (Business Combinations: Purchase Method Procedures) and the objectives of this project are to improve certain purchase accounting rules and practices to increase (1) the transparency of information to users of financial statements, and (2) the consistency with the FASB's Conceptual Framework. The FASB expects to issue an exposure draft for this follow up project in the first quarter of 2004.

Historically, many business combinations involving short-duration contracts had used the acquiree's recorded account balances as the allocated amounts for insurance-specific items in purchase accounting. In purchase business combinations involving acquisitions of property and casualty insurance companies, changes in liabilities for claim losses and loss adjustment expenses of an acquired insurance company ordinarily were made prior to the sale date through losses incurred in the seller's income statement rather than through purchase accounting adjustments. Some believe this was consistent with the SEC's Staff Accounting Bulletin (SAB) No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*.

In 1999, SAB No. 100, *Restructuring and Impairment Charges (Topic 2-A)*, clarified that receivables, liabilities, and accruals should be recorded in the purchase price allocation at their fair value. Frequently, fair values are based on estimations of the underlying cash flows to be received or paid, discounted to their present value using appropriate current market interest rates. Insurers should be aware that fair value encompasses more than discounting. FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides a good framework for utilizing cash-flow techniques in estimating fair value.

The SEC staff notes that companies that engage in a purchase business combination should record the acquired company's liabilities using their best estimate of fair value at the date of the business combination. If a registrant believes that it has unique facts and circumstances such that it should not recognize an acquired company's liabilities or accruals at fair value, the registrant should consider preclearing its proposed accounting with the SEC staff.

Surplus Enhancement

In all audits of GAAP basis and statutory accounting practices (SAP) basis financial statements, consideration should be given to the effects of unusual transactions as well as accounting differences on solvency and the adequacy of the company's SAP-basis capital and surplus. Unusual transactions should be evaluated that materially affect SAP-basis income or surplus, or transactions for which the effects on SAP-basis financial statements would be substantially different from the effects on GAAP-basis financial statements. That evaluation is especially important when an insurer's surplus is at or near minimum levels or if an insurer's risk-based capital ratio is at or near a regulatory action or control level.

In addition, an auditor should be alert to significant and unusual transactions or events at or near year-end that may require significant judgment about the proper accounting treatment, including the following:

- Financially oriented reinsurance transactions
- Changes in reserve estimates
- Asset impairments
- Reinsurance collectibility
- Sale/leaseback transactions of statutory non-admitted assets

- "Parking" of securities
- Loaning or borrowing securities
- Intercompany transactions
- Transactions involving SPEs/VIEs
- Asset swaps
- Asset reclassifications
- Other types of potential "window-dressing" transactions

SOP 94-1, *Inquiries of State Insurance Regulators*, as amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, requires that, if a permitted accounting practice is material to an insurance enterprise's financial statements, the auditor obtain sufficient competent evidential matter to corroborate management's assertion that the accounting treatment is permitted. In many situations, that requirement will cause the auditor to obtain written confirmation, on an annual basis, from the domiciliary state insurance department that the accounting practice continues to be permissible.

If the financial effect of such permitted practices is material, either individually or in the aggregate, to a company's SAP-basis surplus, sufficient competent evidential matter should be received before the issuance of an auditor's report on either the company's GAAP-basis or SAP-basis financial statements.

FASB Statement No. 133 Implementation Guidance

The Derivatives Implementation Group (DIG) helps the FASB staff answer significant questions that companies face when implementing FASB Statement No. 133.

The FASB staff has issued guidance on numerous FASB Statement No. 133 implementation issues, and this guidance can be obtained from the FASB Web site at www.fasb.org. Following is a listing of the insurance-product-related topics that were addressed, together with a brief discussion of the nature of each issue and the date of FASB clearance. This list is intended to highlight to auditors of insurance companies those areas where the application of FASB Statement No. 133 may be required. In addition to the issues listed below, there are several other FASB Statement No. 133 Implementation Issues that are applicable to companies operating in all industries; such issues also may be relevant to an audit of an insurance company.

Topic	*Guidance*
A16—Definition of a Derivative: Synthetic Guaranteed Investment Contracts (March 14, 2001)	Synthetic guaranteed investment contracts meet the definition of *derivatives* in accordance with paragraph 6 of FASB Statement No. 133.
B7—Embedded Derivatives: Variable Annuity Products and Policyholder Ownership of Assets (June 23, 1999)	Traditional variable annuity products do not contain embedded derivatives that warrant separate accounting under FASB Statement No. 133 even though the insurer, rather than the policyholder, actually owns the assets.
B8—Embedded Derivatives: Identification of the Host Contract in a Non-Traditional Variable Annuity Contract (revised September 25, 2000)	Nontraditional variable annuity contracts are distinguished from traditional variable annuity contracts by the fact that investment risk associated with the assets backing the nontraditional variable annuity contracts is shared between the issuer and the policyholder. The host contract for a nontraditional variable annuity contract is the traditional variable annuity portion of the contract (that is, without the nontraditional embedded components).
B9—Embedded Derivatives: Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options (December 6, 2000)	The economic characteristics and risks of the embedded derivative (market-adjusted value prepayment option) in a market value annuity contract are clearly and closely related to the economic characteristics and risks of the host contract and, therefore, need not be bifurcated in accordance with paragraph 12 of FASB Statement No. 133.
B10—Embedded Derivatives: Equity Indexed Life Insurance Contracts (July 28, 1999)	The existence of a death benefit provision does not exclude the entire equity-indexed life insurance contract from being subject to FASB Statement No. 133 for either the issuer or the policyholder because the policyholder can obtain an equity-linked return by exercising the surrender option before death.
B25—Embedded Derivatives: Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period	Deferred variable annuity contracts may contain minimum benefit guarantees in either the accumulation or payout phases of the contract. This issue provides derivative accounting guidance for four separate minimum guarantee scenarios.

Topic	*Guidance*
	Revisions to implementation guidance relate to a period-certain-plus-life-contingent variable-payout annuity contract.
B26—Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts (March 14, 2001)	A property and casualty contract that provides for the payment of benefits and claims as a result of both an identifiable insurable event and changes in a variable would not contain an embedded derivative instrument that is required to be separately accounted for under FASB Statement No. 133 provided (1) benefits and claims are paid only if an identifiable insurable event occurs (for example, theft or fire), (2) the amount of the payment is limited to the amount of the policyholder's incurred insured loss, and (3) the loss is not virtually certain to occur.
B27—Embedded Derivatives: Dual-Trigger Financial Guarantee Contracts (March 14, 2001)	A financial guarantee insurance contract for which payment of a claim is triggered only by the occurrence of the insured's credit losses exceeding a specified level on its loans held (though the amount of the payment is affected by the credit losses in a customized pool of loans by third parties exceeding the same specified level) is an insurance contract that is not subject to FASB Statement No. 133 requirements because it indemnifies the insured for its actual losses incurred above a specified level. A provision limiting claims in the event the insured's credit losses exceed the credit losses in a referenced pool or index of consumer loans represents a type of deductible, rather than an embedded derivative that warrants separate accounting under FASB Statement No. 133.
B28—Embedded Derivatives: Foreign Currency Elements of Insurance Contracts (March 14, 2001)	Contracts that pay claims in a currency different from the one in which the loss is measured at a predetermined contract exchange rate are not deemed to have an embedded foreign currency derivative.
B29—Embedded Derivatives: Equity-Indexed Annuity Contracts with Embedded Derivatives (March 14, 2001)	Equity-indexed annuities that contain "point-to-point" or "ratchet design" features qualify as contracts with embedded equity derivatives that must be bifurcated and reported at fair value in accordance with paragraph 12 of FASB Statement No. 133.
B30—Embedded Derivatives: Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts	Equity-indexed annuities contain a debt instrument with an embedded (equity option) derivative. Upon receipt of the consideration for the equity-indexed contract, the issuer is required to allocate a portion of the consideration to the derivative and the remainder to a fixed annuity host contract. Interest credited and changes in the fair value of the derivative

(*continued*)

Topic	*Guidance*
	should be recognized in earnings. The host contract should be accreted to the minimum account value at the end of the contract using the effective yield method. A minimum liability shall not be recorded if, prior to the maturity of the contract, the aggregate of the host account value and the market value of the derivative is less than the value of the contract on a FASB Statement No. 97 basis (that is, without bifurcating the derivative).
B31—Embedded Derivatives: Accounting for Purchases of Life Insurance (July 12, 2001)	FASB Technical Bulletin 85-4 prescribes the accounting for life insurance contracts commonly referred to as COLI (corporate-owned life insurance), BOLI (business-owned life insurance), and key-man insurance. This accounting treatment is applicable even though these insurance contracts include derivative-like provisions that would otherwise require separate accounting as derivatives under paragraph 12 of FASB Statement No. 133.
B36—Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments (April 2003)	An instrument that incorporates credit risk exposures that are either unrelated or only partially related to the creditworthiness of that instrument's obligor has an embedded derivative that is not considered "clearly and closely related" to the economic characteristics and risks of the host contract. B36 affects the accounting for credit-linked notes that incorporate a third party's credit (or default) risk and modified coinsurance arrangements between reinsurers and ceding insurance companies and similar arrangements, which typically include a provision for passing a return that is linked to the performance of investments held by the ceding company to the reinsurer. The scope of B36 encompasses any receivable or payable where the interest is determined by reference to an actual pool of assets (unless the pool were comprised entirely of risk-free debt securities and/or real estate) or determined by any index other than a "pure" interest rate index.
C1—Scope Exceptions: Exception Related to Physical Variables (February 17, 1999)	If a contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of FASB Statement No. 133 because it would not meet the exclusion in paragraph 10(e)(1) of FASB Statement No. 133.
C7—Scope Exceptions: Certain Financial Guarantee Contracts	For financial guarantee contracts, the scope exception in paragraph 10(d) of FASB Statement No. 133 does not apply if such contracts do not require exposure

Topic	Guidance
	to and incurrence of a loss as a precondition for payment. Furthermore, to qualify for the scope exception in paragraph 10(d), the compensation paid under such contracts cannot exceed the amount of the losses incurred by the guaranteed party. The FASB initially cleared this issue on July 28, 1999; however, at the March 13, 2002, meeting, the FASB decided to amend paragraph 10(d) of FASB Statement No. 133. That amendment will be included in an exposure draft containing various amendments of FASB Statement No. 133. Accordingly, the guidance in this issue may be revised or rescinded if a proposed amendment to FASB Statement No. 133 is finalized.
G4—Cash Flow Hedges: Hedging Voluntary Increases and Interest Credited on an Insurance Contract Liability (July 28, 1999)	FASB Statement No. 133 would permit an insurance company to qualify for cash-flow hedge accounting if it is hedging the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain whole life, universal life, repetitive premium variable annuity, and single premium variable annuity contract liabilities. However, to qualify for cash-flow hedge accounting, changes in the hedged interest payments attributable to the hedged risk must be sufficiently correlated with the changes in the cash flows of the hedging derivative.

Valuation Spotlight

Deferred Acquisition Costs

Under GAAP, commissions, allowances, and other costs that vary with and are primarily related to the acquisition of new and renewal business are generally deferred and amortized. These deferred amounts, referred to as deferred acquisition costs (DAC), are recorded as an asset on the balance sheet and amortized to income in a systematic manner based on related contract revenues or gross profits (or gross margins as in SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, contracts), as appropriate.

DAC Recognition, Recoverability, and Allocation

Unamortized acquisition costs are subject to recoverability and loss-recognition testing as outlined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. In addition, DAC should be allocated to or directly identified with contract types or lines of businesses so these costs can be amortized over the life of the related contracts. Auditors are reminded to assess DAC recoverability and DAC allocation on their audits. Some suggestions include:

- The auditor can review the recoverability of DAC by comparing GAAP net premium with gross premiums. For unfavorable results, review loss recognition studies by line of business or contract type for possible loss recognition situations.
- The auditor can review studies comparing actual and projected experience (gross profits, mortality, morbidity, persistency, investment yields, and expenses) with those assumed for adverse deviation from the original assumptions that may indicate potential loss-recognition situations.
- For identified loss recognition situations, the auditor can determine that DAC balances are appropriately reduced or that premium deficiency liabilities are accrued.
- The auditor can evaluate reasonableness and consistency of cost allocations to lines of business or contract types and obtain explanations for unusual items.

Further DAC Considerations

Amortization. For investment contracts, universal life-type contracts, and participating policies of mutual insurers, FASB Statement No. 97 and SOP 95-1 require that DAC be amortized over the life of a book of business at a constant rate based on the present value of estimated gross profits (EGPs) or margins. In contrast to products accounted for under FASB Statement No. 60, for which reserving and DAC assumptions are "locked in" unless premium deficiency/loss recognition is triggered, assumptions used in the FASB Statement No. 97 and SOP 95-1 calculation of DAC are "unlocked" and are subject to periodic review. Accordingly, for FASB Statement No. 97 and SOP 95-1 products, management should regularly reevaluate the underlying assumption used to determine its "best estimates" of profits and revise DAC calculations as necessary. With each reporting period, DAC amortization should be revised to reflect the most current estimates of gross profits. In light of current competitive market conditions and changing interest rates, the auditor may want to challenge management's persistency assumptions and future gross margins incorporated in these analyses.

Investment Returns. For variable life insurance and annuity contracts, many companies use an approach, sometimes referred to as "reversion to the mean," by which the investment return assumptions in the company's EGP model reflects investment return performance over the remaining expected life of the contract such that investment return performance over the entire life of the contract achieves the company's initial expected long-term growth rate given past market performance. Other companies assume significant near-term market corrections to return to modeled account balances or use similar adjustment methodologies that in the current market environment imply significant short-term positive market performance. When using these various approaches, companies may impose various judgmental limits on the return assumptions.

Regardless of the approach used to develop investment return assumptions, the prolonged decline in the equity markets and the current interest rate environment require the auditor to challenge the reasonableness of management's best estimate assumptions, accounting estimation policies for selecting their assumptions (that is, when and how to adjust their assumptions), and whether those assumptions are consistent with assumptions the company uses for other purposes (for example, the company's financial plan). Items to consider may include the composition of the portfolio, the long-term and short-term asset appreciation/growth rate assumptions, and the amortization period.

For universal life and deferred annuity contracts and the general account component of variable contracts, companies must make assumptions about interest rates to be earned on fixed income investment.

Persistency and Lapse Rates. Since an increasing number of life and annuity policies contain features that were previously uncommon in traditional policy offerings, historical persistency rates may not be indicative of future persistency rates. Given competitive market conditions in which consumers are attempting to maximize yields within their risk tolerance levels, the life and annuity markets have experienced high rates of policy replacement, both external and internal, in recent years. Accordingly, practitioners may want to challenge persistency assumptions used in the calculation of DAC amortization.

Fees and Expenses. With the emergence of accommodations to meet competition, such as increases in crediting rates, bonus interest, persistency bonuses, immediate bonus credits, and decreases in administrative charges to customers, EGPs may have declined relative to prior years. In auditing DAC, the auditor may want to review assumptions used to estimate future gross profits for consistency with management's description of its business as well as other management analyses. If inconsistencies are identified, the auditor may want to consider their implications in the determination of DAC. To the extent it is determined that assumptions used do not represent management's best estimate, the auditor should propose that management adjust those estimates and record any required adjustment.

Deferral of Costs. For costs that are initially being deferred in the current year, the auditor should consider whether costs indeed meet the criteria for acquisition costs in FASB Statement No. 60—that is, whether they vary with and are primarily related to the acquisition of new and renewal insurance contracts. Care must be exercised to note the difference between changes in estimates and changes in accounting policies for costs that are deferred. Given the SEC's concerns regarding the nature of the acquisition costs being deferred, auditors should carefully consider their procedures in these situations.

DAC Related to Internal Replacements. GAAP concerning the treatment of existing DAC related to internal replacements is unclear. FASB Statement No. 97 requires the writeoff of existing DAC when a FASB Statement No. 97 universal life contract replaces a FASB Statement No. 60 traditional life insurance contract. However, GAAP is silent about whether to write off or maintain DAC if a policy is replaced with a comparable product (for example, if a FASB Statement No. 97 deferred annuity replaces another FASB Statement No. 97 deferred annuity). To the extent an insurer follows a policy of maintaining DAC for policies replaced by another similar contract, management should document the rationale for its position and that such rollover DAC continues to be recoverable.

In March 2003, AcSEC issued an exposure draft of an SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*. The purpose of the exposure draft is to provide guidance on determination of the proper accounting by insurance enterprises for DAC on internal replacements other than those specifically described in FASB Statement No. 97. Areas covered include (*a*) the definition of an internal replacement, (*b*) determining whether contracts or modifications involved in an internal replacement result in "substantially unchanged" or "substantially changed" contracts, (*c*) accounting for internal replacements that are substantially unchanged or substantially changed, (*d*) sales inducements offered in conjunction with an internal replacement, (*e*) the costs and assessments related to an internal replacement, and (*f*) recoverability. The provisions of the proposed SOP would be effective for internal replacements occurring in fiscal years beginning after December 31, 2004, with earlier adoption encouraged. The effect of initially adopting this SOP would be reported prospectively with restatement of prior issued financial statements prohibited. The Accounting Standards Executive Committee (AcSEC) is currently working with FASB to finalize this SOP.

Capitalization and Valuation of Mortgage-Servicing Rights

Some insurance entities have been significantly increasing their real estate loan portfolios, as well as enhancing their servicing portfolios of loans sold in the secondary market with servicing retained by the entity. Entities in recent years have been much more likely than in the past to retain servicing for loans sold to secondary market investors. Not only has the number of companies that are servicing portfolios grown considerably, but the size and dollar amount of entities' servicing has also increased. Conversely, the recent refinancing boom has adversely affected certain institutions, as borrowers have moved to other institutions in the highly competitive market.

The value of associated mortgage-servicing rights (MSRs) is an important area for an auditor and may have a significant effect on a client's financial statements this year or in the near future. More institutions are being faced with the challenge of trying to record these assets in compliance with FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Additionally, the various mortgage-related entities, such as the Department of Housing and Urban Development (HUD), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC, also known as Freddie Mac), and Government National Mortgage Association (GNMA, also known as Ginnie Mae) have various audit and reporting requirements.

Although a book could be written about auditing all components of accounting for MSRs, this alert will focus on common pitfalls seen with accounting for MSRs up front, during the initial capitalization stage, and ongoing, during subsequent impairment valuations. The assumption has been made that the auditor has already performed an evaluation to determine that the sale met the "true sale" requirements of FASB Statement No. 140 and a transfer of assets has occurred.

Common Pitfalls to Look for in Reviewing Initial Capitalization

Due to the complexity of accounting for mortgage-servicing rights, there are, unfortunately, several pitfalls one could encounter during the up front initial capitalization stage.

Failure to properly perform the relative fair-value allocation. In accordance with FASB Statement No. 140, servicing assets retained in a sale should be initially measured by allocating the previous carrying amount between the loans sold and the mortgage-servicing rights retained, based on their relative fair values at the date of sale.

Often, an institution will misinterpret or shortcut this step. The typical shortcut involves recording the mortgage-servicing rights at fair value without performing an allocation. Failure to perform the relative fair-value allocation will usually result in the overcapitalization of the mortgage-servicing rights.

Estimating the fair value of mortgage-servicing rights using unsupported shortcut methods. In order to properly record mortgage-servicing rights, one needs to be able to obtain a fair market value. In lieu of doing the work required to calculate and/or obtain a fair market value, institutions may be tempted, on occasion, to resort to unsupported shortcut methods. The most common shortcut is the application of a set percentage to the principal balance of the loans sold, such as 0.8 percent or 1 percent. In those instances, no documentation is usually maintained in support of the percentage factors.

Estimating the fair value of mortgage-servicing rights using an in-house spreadsheet model. Although in-house modeling can be a valid method to calculate the fair value of mortgage-servicing rights, the risk of improperly calculating the value greatly increases and the auditor will, in most cases, need to increase audit test work, if material, to ensure that the valuation is not grossly misstated. The auditor should be sure to cover the following issues:

- Does the institution have the necessary expertise to be able to properly model the servicing rights in-house?
- Who developed the spreadsheet model?
- What are the main key assumptions being used in the valuation and are they consistent with those used by an independent broker?
- What are the sources of the assumptions and are they documented and updated in a timely manner?
- Is the institution using market-based or internally derived assumptions?
- How is the model calculating the market valuation, and can the auditor reproduce the end calculation using similar assumptions?

- Is the final calculation prepared by the institution indicative of "true" market value, and has an independent broker valuation been performed to validate the reasonableness of the internal calculation?
- Does the institution obtain an independent appraisal?

Common Pitfalls to Look for in Reviewing Impairment Valuation

According to FASB Statement No. 140, an entity needs to subsequently evaluate and measure the servicing asset for impairment. During this stage, the auditor needs to be on the watch for several potential issues.

Failure to properly evaluate impairment at the strata level. An entity should have stratified its mortgage-servicing rights in accordance with the guidelines set forth in FASB Statement No. 140. The auditor needs to evaluate the impairment calculation to determine whether the institution stratified its mortgage-servicing rights and evaluated for impairment at the strata level. The risk exists that the institution may just assess impairment by comparing total book value of all mortgage-servicing rights against the total market value for the entire portfolio. This would result in a netting effect of any stratum with cushions against stratum with impairment, and is clearly prohibited in FASB Statement No. 140.

Writing up the mortgage-servicing rights asset in excess of book value. When an entity performs the impairment valuation at the strata level, care must be given to ensure that no strata is written up over book value. In other words, when comparing book value for a strata with its related market value, the institution cannot write up the asset to market value if market value is greater. The impairment valuation should result in the asset being recorded at the lower of cost or market.

Failure to properly value the mortgage-servicing rights using an in-house model. As noted above, sometimes an entity will attempt to value the mortgage-servicing rights in-house, and the potential pitfalls noted earlier for in-house modeling during the capitalization stage also apply for the fair values calculated for use in the subsequent impairment valuations.

Caution in Use of Independent Broker Valuation. Often, an entity will choose to rely on an independent broker valuation for its fair-market value quotes. In those cases, an auditor still has to be on the watch for the following:

- *Is the broker truly independent?* The auditor may have reason to question the independence of the broker if the institution consistently uses the broker for other services and the broker provides the valuation free of charge as a favor. The broker would have incentive to favorably value the servicing rights in order to maintain the broker-client relationship.
- *What assumptions were used by the broker?* In most cases, the assumptions used by the broker will be market based; however, the auditor will want to inquire whether the institution provided any input on the assumptions used by the broker in the calculation. Additionally, the auditor may want to consider obtaining a Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, report.
- *Consistent use of broker valuations.* When the broker valuation is obtained, the broker will often not provide a set value but will provide a range of values with a midpoint fair value. The auditor should be alert to the consistency in which the institution selects the fair value for impairment valuation from the range. The entity should strive to be consistent with policies, and if it is determined that the midpoint range will be used, then consistency is key.

If the auditor questions the validity or independence of the broker valuation, a second independent broker valuation may be required. SAS No. 73, *Using the Work of a Specialist*, (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to the auditor when relying on information provided by a person or firm possessing special skills outside the field of auditing or accounting. Additionally, one can refer to SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and its companion Audit Guide *Auditing Derivative Instruments*, *Hedging Activities, and Investments in Securities* (product no. 012520kk) for additional information.

Additional Audit, Accounting, and Regulatory Guidance

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, and *Audit of Credit Unions*; and SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provide guidance related to mortgage-loan servicing. The aforementioned Guides and SOP will be combined into a combined AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies,* to be issued in early 2004.

Additionally, the FASB published a Special Report on February 15, 2001, that addresses the most frequently asked questions about FASB Statement No. 140. On April 19, 2001, the FASB staff published a set of questions and answers about isolation of financial assets transferred by banks and other entities, focusing on rights of redemption. On August 7, 2001, the FASB staff published a set of questions and answers about the limitations on the activities of a qualifying special-purpose entity (QSPE) set forth in paragraphs 35 through 44 of FASB Statement No. 140. Moreover, the FASB issued an exposure draft entitled *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140* to further define the parameters of FASB Statement No. 140.

For those institutions that have mortgage-servicing operations, the auditor should evaluate whether the institution is complying with the relevant accounting requirements. The auditor should gain assurance that the institution is properly recording the asset (or liability) and gain or loss on sale when loans are sold with servicing retained. Assurances should also be made that the institution is properly amortizing the mortgage-servicing rights and that procedures are in place to properly assess fair value for potential impairment.

Apart from the proper accounting treatment for loans sold, and accounting for retained servicing, the auditor may also want to evaluate the internal control of the servicing operations. The institution will have numerous financial and compliance obligations and responsibilities, such as (1) collecting and remitting loan payments, (2) ensuring compliance with federal and state regulations covering escrow accounts and other servicing requirements, (3) compliance with the seller servicing agreement with a third party, (4) properly collecting on delinquent accounts, and (5) collecting and paying taxes and insurance. Failure to properly comply with any of these requirements could have serious financial impact on the institution.

Additional FASB Statement No. 140, *Auditing Considerations*

For clarity, the aforementioned mortgage-servicing rights discussion assumes that the two-step isolation criteria described in FASB Statement No. 140 have been properly met. It is important for the auditor to be cognizant that some clients may be selling loans in single-step transactions with continued involvement while at the same time derecognizing the related assets and liabilities. Paragraph 9 of FASB Statement No. 140 provides specific conditions under which control is considered to be surrendered. One such condition is that the transferred assets have been isolated from the transferor and put beyond the reach of creditors, even in bankruptcy or receivership. Since this condition is a legal isolation, the use of a legal interpretation as evidential matter to support management's assertion that a transfer has met the isolation criteria, may be required. In that case, the auditor can refer to Auditing Interpretation No. 1, *The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criteria in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140,* of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336.01-.21).

In a minority of situations, legal interpretation may not be needed. Paragraph .05 of Interpretation No. 1 of SAS No. 73 states that use of a legal specialist may not be necessary to obtain competent evidential matter to support management's assertion that the isolation criterion is met in certain situations, such as when there is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.

The Interpretation's related footnote 4 in paragraph .05 references EITF Topic D-99, *Questions and Answers Related to Servicing Activities in a Qualifying Special-Purpose Entity Under FASB Statement No. 140*, for guidance on the meaning of "no continuing involvement." However, it is important to note that many isolation transfers do not meet this "no further involvement of any kind" criteria. The auditor should discuss with clients the importance of obtaining a legal opinion to support isolation criteria.

Deferred Tax Asset Valuation

Auditors are reminded to assess the reasonableness of the deferred tax asset valuation allowance as it relates to such items as unrealized capital gains and losses and net operating and alternative minimum tax credit carryforwards. Deferred tax assets are reduced by a valuation allowance if, based on all available evidence (both positive and negative), it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the tax benefit will not be realized. The weight given to the potential effect of negative and positive evidence should commensurate with the extent to which it can be objectively verified. Positive evidence includes tax-planning strategies (for example, strategies that would, if necessary, be implemented to accelerate taxable income to utilize expiring net operating loss carryforwards, change the character of temporary differences from ordinary to capital, or switch from tax-exempt to taxable investments). The valuation allowance recorded should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

Statutory Considerations

It should be noted that under the National Association of Insurance Commissioners (NAIC) Codification, Statement of Statutory Accounting Practices (SSAP) No. 10, *Income Taxes*, establishes SAP for current and deferred federal taxes, as well as foreign income taxes. Under SSAP No. 10, insurance companies are required to record deferred income taxes, subject to an admissibility test. Although SSAP No. 10 created several implementation questions, the majority of these are addressed in Q&A 10, *A Guide to Implementation of SSAP No. 10 on Accounting for Income Taxes: Questions and Answers*. Particular attention should be paid to Q&A 10's discussion of the calculation of an insurance company's admitted deferred tax asset, the calculation and reporting of tax contingency reserves, the definition of "expected to be realized," the use of tax-planning strategies, and the presentation and disclosure of income taxes in an insurance company's financial statements.

For insurance companies that file a consolidated tax return with their common parent, all aspects of the deferred tax calculations and admissibility test must be made on a separate company basis. An auditor should consider a benefit recorded for an insurer's loss that offsets other member's income in a consolidated group, if the tax sharing agreement provides for a tax benefit to the insurer with the loss.

Financial Statement Fraud

Considering fraud in a financial statement audit is always a crucial responsibility for auditors. As such, auditors should familiarize themselves with and follow the guidance related to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which was recently added to the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies,* and *Life and Health Insurance Companies*. That guidance provides valuable industry-specific implementation guidance related to SAS No. 99. In particular, the guidance in those Guides addresses areas such as:

- Discussion among engagement personnel regarding the risks of material misstatement due to fraud.
- Obtaining the information needed to identify the risks of material misstatement due to fraud.
- Identifying risks that may result in a material misstatement due to fraud.

- Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.
- Responding to the results of the assessment.

Implementation Guide

The Practice Aid entitled *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* includes topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids, such as specialized insurance industry fraud risk factors, common frauds, and extended audit procedures.

Regulatory Developments

Recent Statutory Accounting Principles

The NAIC continues to create and clarify statutory accounting guidance for certain insurance enterprises through an ongoing maintenance process. The *Accounting Practices and Procedures Manual* was published by the NAIC as of March 2003 (the revised Manual), which includes modifications of and additions to the previously issued Manual (as of March 2002). The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the revised Manual except as prescribed or permitted by state law. Two new SSAPs were effective for implementation on January 1, 2003:

1. SSAP No. 85, *Claim Adjustment Expenses, Amendments to SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses* addresses the accounting treatment for claim adjustment expenses on accident and health contracts.
2. SSAP No. 86, *Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions* addresses the concepts outlined in FASB Statement No. 133 and establishes a statutory accounting model for derivative transactions entered into after January 1, 2003. Alternatively, an insurer may choose to apply SSAP No. 86 to all derivatives to which the insurer is a

party as of January 1, 2003. Some of the more significant requirements of SSAP No. 86 that differ from FASB Statement No. 133 include the following:

a. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

b. Insurers should not bifurcate effectiveness. Derivative instruments that meet the criteria of an effective hedge shall be valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). Derivative instruments that do not meet or no longer meet the criteria of an effective hedge shall be accounted for at fair value.

c. Changes in the fair value of a derivative that does not meet the criteria of an effective hedge are recorded as unrealized gains or losses.

d. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. Therefore, an insurer cannot hedge a portfolio of dissimilar risks.

In addition, Issue Paper No. 123, *Accounting for Pensions, a Replacement of SSAP No. 8*, was adopted during the Fall 2003 NAIC National meeting. The Statutory Accounting Principles Working Group will hold a public hearing at the Winter 2003 NAIC National meeting to vote on the related SSAP in an attempt to clarify statutory guidance to require the change in the additional minimum pension liability to be recorded as a component of unassigned funds. An auditor should monitor this issue to understand whether statutory guidance is updated prior to year-end, and the related impact it would have. Any change resulting from the adoption of this statement should be recorded as a change in accounting principle in accordance with SSAP No. 3, *Accounting Changes and Corrections of Errors*.

Issue Paper No. 123 also clarifies that the incremental transition liability described in paragraph 19.b of SSAP No. 8 should be "carved out" when determining the accumulated benefit obligation used to calculate the additional minimum pension liability. This allows insurers that originally elected to defer the incremental liability upon adoption of the NAIC *Accounting Practices and Procedures Manual* (Version effective January 1, 2001), to continue to amortize this liability as a component of net periodic pension cost over a period not to exceed 20 years.

SSAP No. 87, *Capitalization Policy, an Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82*, was also adopted during 2002, and will become effective January 1, 2004. SSAP No. 87 requires insurance entities to establish a *predefined threshold* below which items are expensed. This SSAP may require significant system enhancements for insurance entities that have a large number of asset classes.

Additionally, 19 new Interpretations were adopted during 2002 and incorporated in the revised Manual.

SEC Guidance About Non-GAAP Financial Measures

In January 2003, the SEC published its final rule to implement Section 401(b) of the Sarbanes-Oxley Act. Section 401(b) required the SEC to issue a rule about the disclosure of pro forma financial information in any reports filed with the SEC, or in any public disclosures or press releases. The SEC rule adopts the term *non-GAAP financial measures* rather than *pro forma financial information* to eliminate confusion with pro forma disclosures that are required under existing SEC rules and regulations.

As required by the Act, whenever a company presents a non-GAAP financial measure, newly adopted Regulation G will require presentation of a numerical reconciliation to the most directly comparable measurement calculated using GAAP. Regulation G also explicitly prohibits the presentation of inaccurate or misleading non-GAAP financial measures. Regulation G applies to public disclosures made on or after March 28, 2003.

The final SEC rule defines a *non-GAAP financial measure* as a numerical measure of a company's historical or future financial performance, financial position, or cash flows that excludes (includes) amounts, or is subject to adjustments that have the effect of excluding (including) amounts, that are included (excluded) in the most directly comparable measure calculated in accordance with GAAP.

The definition of non-GAAP financial measures specifically excludes measures that are required to be disclosed by GAAP, SEC rules, or an applicable system of regulation imposed by a government, governmental authority or self-regulatory organization. Therefore, statutory-basis financial ratios (e.g., combined ratios) used by insurance registrants in SEC filings to describe the results of operations are considered outside the scope of the non-GAAP rules so long as those ratios are identical (in terms of both formula and result) to those presented in required filings with insurance regulators.

In addition to the newly adopted Regulation G, the SEC also amended Regulations S-K and S-B to impose additional requirements and restrictions on the disclosure of non-GAAP financial measures in SEC filings. Among other things, the amendments to Regulations S-K and S-B prohibit the presentation of performance measures that exclude charges or gains identified as "nonrecurring, infrequent or unusual," unless the excluded items meet certain conditions. Many insurance companies use the term *operating earnings* (or similar non-GAAP terms) in discussing financial results within SEC filings. Insurance companies have defined *operating earnings* in a variety of different ways; however, the most common definition is net income excluding after-tax realized investment gains and losses. Under the new non-GAAP rules, the term *operating earnings* is prohibited from being used in SEC filings because it is considered a performance measure that is adjusted to eliminate or smooth items (i.e., realized investment gains and losses), which have either occurred in the prior two years or are likely to recur within two years from the balance-sheet date. The SEC staff required several insurance companies to restate form 10-Q filings in 2003 because the registrants originally used the term *operating earnings* or a similar term in discussing results of operations. The SEC staff also has required insurance companies to discontinue using *operating earnings* in press releases.

For further discussion of the Sarbanes-Oxely Act, see the AICPA general *Audit Risk Alert—2003/04*.

Consideration of the Examiner's Handbook

The AICPA NAIC Task Force reviewed a revision to the Model Audit Rule to emphasize that auditors shall consider the procedures in the NAIC *Financial Condition Examiner's Handbook* (the Examiner's Handbook). Although the AICPA supports increased communication with regulators, it does not require auditors to perform procedures from the Examiner's Handbook that they would not have otherwise performed as part of a GAAS audit. Rather, this revision places greater emphasis on giving consideration to the procedures contained in the Examiner's Handbook.

Reminder—Access to CPA Audit Documentation

An external auditor is required by the NAIC Model Audit Rule to provide timely access to or copies of audit documentation when requested by regulators.

Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339.01–.15), addresses the responsibilities of an auditor when a regulator requests access to audit documentation.

The AICPA's task force on NAIC matters worked actively with subgroups of designated examiners and NAIC representatives during 2003 to pursue ways to increase the examiners' reliance upon the statutory audit and use of underlying audit documentation. Suggested protocols were forwarded to the Financial Examiners Handbook Technical Group for consideration of possible revisions to the Examiner's Handbook.

The AICPA NAIC Task Force helped to establish a four-step process to provide a protocol for financial examiners that are having difficulty in pursuing a resolution of (1) questions with respect to a firm's individual engagement to perform a statutory audit, (2) difficulties in gaining access to working papers, or (3) the regulator concerns about the work performed by the CPA. Should a financial examiner determine additional response is required, after informing appropriate management, the financial examiner would contact the following individuals in this suggested order, as needed:

1. The engagement partner
2. The designated national Firm representative
3. Chair of the Insurer's Audit Committee
4. State Board of Accountancy, Ethics (or Quality Review) Committee, or other regulatory bodies deemed appropriate

Firms or individual practitioners performing statutory audits of regulated insurance entities who wish to designate a national firm representative should contact NAIC representatives Annette Knief at (816) 783-8006 or Julie Glaszcz at (816) 783-8132.

Terrorism Risk Insurance Act of 2002

The market for terrorism risk insurance was severely disrupted by the events of September 11, 2001. The terrorism resulted in reinsurers choosing to no longer covering terrorism risk or if covered, the cost became extremely expensive. On November 26, 2002, the President signed into law the Terrorism Risk Insurance Act (TRIA) of 2002. TRIA, which became effective immediately, established a temporary federal program of shared public and private compensation for insured commercial property and casualty losses resulting from acts of terrorism.

Accordingly, terrorism exclusions on existing insurance policies were removed and all policyholders had the ability to secure coverage for terrorism risk. The TRIA places the federal government temporarily in the terrorism risk reinsurance business because the program will sunset on December 31, 2005. Under the program, once an insurer has suffered a loss equal to its deductible, the United States Treasury will cover 90 percent of the losses above the deductible. The insurer's deductible increases over the life of the program. In 2003, the deductible is equal to 7 percent of the insurer's direct earned premiums for commercial property and casualty insurance in calendar year 2002. The percentage increases to 10 percent in the second year of the program and to 15 percent in the last year of the program. TRIA also provides the

Treasury with the authority to recoup federal payments via policyholder surcharges. The maximum amount of any potential policyholder surcharge that can be imposed is 3 percent per year.

The NAIC memberships have adopted model disclosure forms to assist insurers in complying with the TRIA. The model disclosure forms may be used by insurers to meet their obligation under the rules, provide policyholders of the status of current coverage, and, in some cases, make a selection regarding future insurance coverage for acts of terrorism. Insurers must comply with state law and the act, and are encouraged to review the disclosure forms in light of their current policy language, state legal requirements, and the provisions of the TRIA.

New Auditing and Attestation Pronouncements, Quality Control, and Other

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. The Public Company Accounting Oversight Board (PCAOB) sets auditing and attestation standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org for information about its activities and any recently issued standards. You may also look for announcements of newly issued standards in the *CPA Letter, Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 101	*Auditing Fair Value Measurements and Disclosures*
Audit Guide	*Audits of State, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
SOP 03-2 (Not applicable to attest engagements on public companies)	*Attest Engagements on Greenhouse Gas Emissions Information*

Audit Interpretation No. 15 of SAS No. 58	*Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations*
Audit Interpretation No. 16 of SAS No. 58	*Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt from Securities and Exchange Commission Registration Under the Investment Company Act of 1940*
Amendment to Audit Interpretation No. 2 of SAS No. 31	*The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals*
PCAOB Rule 3100T (Applicable to public company audits only)	All registered public accounting firms are required to adhere to the PCAOB's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices.
PCAOB Rule 3200T (Applicable to public company audits only)	In connection with the preparation or issuance of any audit report, a registered public accounting firm and its associated persons shall comply with generally accepted auditing standards as described in SAS No. 95 as in existence on April 16, 2003
PCAOB Rule 3300T (Applicable to public company audits only)	In connection with an engagement (*1*) described in the AICPA's Auditing Standards Board's (ASB) Statement on Standards for Attestation Engagements (SSAE) No. 10, and (*2*) related to the preparation or issuance of audit reports for issuers, a registered public accounting firm and its associated persons shall comply with the SSAEs and related interpretations and SOPs as in existence on April 16, 2003.
PCAOB Rule 3400T (Applicable to public company audits only)	A registered public accounting firm and its associated persons shall comply with quality control standards as described in (*1*) the AICPA's ASB's Statements on Quality Control Standards as in existence on April 16, 2003, and (*2*) the AICPA SEC Practice Section's Requirements of Membership (d), (f) (first sentence), (l), (m), (n)(1) and (o) as in existence on April 16, 2003.
Revised Government Auditing Standards	The GAO issued a comprehensive revision to Government Auditing Standards (GAS, also known as the Yellow Book) in June 2003.
Auditor's Toolkit (Non-authoritative)	*Auditor's Toolkit for Auditing Fair Value Measurements and Disclosures Under FASB Statements Nos. 141, 142, and 144*
Practice Alert No. 03-1 (Non-authoritative)	*Audit Confirmations*
Practice Alert No. 03-2 (Non-authoritative)	*Journal Entries and Other Adjustments*
AICPA Practice Aid (Non-authoritative)	*Applying OCBOA in State and Local Governmental Financial Statements*

Items having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 101, *Auditing Fair Value Measurements and Disclosures*

The Auditing Standards Board (ASB) has issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328), in January 2003 to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, the statement addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Fair value measurements of assets, liabilities, and components of equity may arise from both the initial recording of transactions and later changes in value. Changes in fair value measurements that occur over time may be treated in different ways under GAAP. For example, GAAP may require that some fair value changes be reflected in net income and that other fair value changes be reflected in other comprehensive income and equity. Although SAS No. 101 provides guidance on auditing fair-value measurements and disclosures, evidence obtained from other audit procedures also may provide evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant evidence about its valuation. The statement is effective for audits of financial statements for periods beginning on or after June 15, 2003.

Auditor's Toolkit for Auditing Fair Value Measurements and Disclosures Under FASB Statements No. 141, 142, and 144

This AICPA publication presents recommendations on the application of generally accepted auditing standards (GAAS) to audits of financial statements that recognize fair-value measurements under the referenced accounting standards. The publication includes discussion of business combinations, goodwill, and other intangibles, impairment, and disposal as these scenarios cover many aspects of an audit. The free publication contains illustrative audit programs and disclosure checklists and is available at http://www.aicpa.org/members/div/auditstd/fasb123002.asp.

New Accounting Pronouncements and Other Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 148	*Accounting for Stock-Based Compensation—Transition and Disclosure—An amendment of FASB Statement No. 123*
FASB Statement No. 149	*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Statement No. 150	*Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*
FASB Interpretation No. 45	*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Interpretation No. 46	*Consolidation of Variable Interest Entities, An Interpretation of ARB No. 51*
SOP 02-2	*Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*
SOP 03-1	*Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and for Separate Accounts*
Practice Aid	*Accounting Trends & Techniques—Employee Benefit Plans*
Technical Questions and Answers in *Technical Practice Aids*	*FASB Statement No. 136, Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*

Of the pronouncements and other guidance listed in the previous table, those having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA literature, contact the member satisfaction center at (888) 777-7077, or go online at www.cpa2biz.com.

SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and for Separate Accounts*

In July 2003, AcSEC issued SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and for Separate Accounts*. The SOP provides guidance on accounting and reporting by insurance enterprises for certain nontraditional long-duration contracts and for separate accounts, including:

- Separate account presentation
- Accounting for an insurance enterprise's interest in a separate account
- Transfers to separate accounts
- Valuation of liabilities
- Accounting for contracts with death or other insurance benefit features
- Accounting for contracts that provide annuitization benefits
- Sales inducements to contract holders

The SOP is effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. The SOP may not be applied retroactively to prior years' financial statements, and initial application should be as of the beginning of an entity's fiscal year. At the date of initial application, an insurance enterprise will have to make various determinations to calculate the cumulative effect of a change in accounting principle from adopting this SOP. Such determinations include qualification for separate account treatment, FASB Statement No. 115 classification of securities in separate account arrangements not meeting the criteria of the SOP, the significance of mortality and morbidity risk, adjustments to contract holder liabilities, and adjustments to estimated gross profits or margins.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that have particular significance to the insurance industry or that may result in very significant changes. Read the AICPA general *Audit Risk Alert—2003/04* for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
AICPA Accounting and Review Services Committee (ARSC)	www.aicpa.org/members/div/auditstd/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by email about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your email address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if available, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed above.

Auditing Pipeline—Nonpublic Companies

New Framework for the Audit Process

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB has issued a suite of seven proposed SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance the auditor's application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding
- A better linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Auditing Pipeline—Public Companies

Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

As of the writing of this Alert, the PCAOB has issued Release No. 2003-017, Proposed Auditing Standard—*An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. For further information, visit the PCAOB Web site at www.pcaobus.org.

Accounting Pipeline

Exposure Draft, *Accounting for Deferred Acquisition Costs on Internal Replacements*

In March 2003, the AcSEC issued an exposure draft of a proposed SOP entitled *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*. The proposed exposure draft provides guidance on accounting by insurance enterprises for DAC on internal replacements outside the scope of Statement No. 97. Areas covered include the definition of an internal replacement, determining whether an internal replacement involves substantially unchanged or changed contracts, accounting for internal replacements that are "substantially unchanged" or "substantially changed," sales inducements offered with internal replacements; and the costs, assessments and recoverability of internal replacements. A final SOP is expected to be issued in the first quarter of 2004.

Exposure Draft, *Financial Highlights of Separate Accounts*

In July 2003, the AcSEC issued an exposure draft of a proposed SOP entitled *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide Audits of Investment Companies*. The exposure draft provides guidance on reporting financial highlights by separate accounts of insurance enterprises and applies to all entities that are considered separate accounts of life insurance enterprises, as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. A final SOP is expected to be issued in the fourth quarter of 2003.

FASB Exposure Draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an Amendment of FASB Statement No. 140*

The FASB has issued an exposure draft entitled *Qualifying Special-Purpose Entities and Isolation of Transferred Assets, an amendment of FASB Statement No. 140*. This exposure draft was issued because (1) by allowing Qualifying Special Purpose Entities to be an exception to consolidation, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, created an incentive for people to convert certain entities to QSPEs and (2) during the analysis of the issue, other elements of FASB Statement No. 140 needed clarification. The exposure draft amends the conditions for a qualifying SPE in FASB Statement No. 140 to:

1. Limit the relationship of a transferor (and its affiliates and agents) with a qualifying SPE.

2. Prohibit any party from being in a position to enhance or protect the value of its own interest in a qualifying SPE by providing financial support for or making decisions about reissuing beneficial interests.

3. Prohibit a qualifying SPE from holding equity instruments.

4. Clarify the requirements related to instruments with maturities after the termination date of the entity.

This exposure draft also provides that if the result of a transfer is the issuance of beneficial interests (whether they are securities, undivided interests, or in some other form), a transferor has not surrendered control of transferred assets in a two-step transfer (used to achieve legal isolation) unless the second step involves a qualifying SPE. Finally, this exposure draft clarifies that, to qualify for derecognition, transferred assets must be isolated from all entities in the consolidated group that includes the transferor with the exception of certain bankruptcy-remote entities.

Resource Central

Presented below are various resources that practitioners engaged in the insurance industry may find beneficial.

On the Bookshelf

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements:

- Audit and Accounting Guide *Audits of Life and Health Insurance Entities* (product no. 012633kk)
- Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* (product no. 012673kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012541kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- *Accounting Trends & Techniques—2003* (product no. 009895kk)
- *Audit and Accounting Manual* (product no. 005133) The manual is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditor's reports, checklists, and engagement letters; management representation letters; and confirmation letters.

AICPA reSOURCE Online

Get access—any time, anywhere—to the AICPA's latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential service, go to www.cpa2biz.com.

CD-ROMS

The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to AICPA Professional Literature products in a Windows format, including *Professional Standards,* Technical Practice Aids, and Audit and Accounting Guides (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Continuing Professional Education

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the insurance industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737186kk (text) and 187086kk (video)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *SEC Reporting* (product no. 736749 (text) and 186749 (video)). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2biz.com, is the AICPA's flagship online learning product. Selected as one of Accounting Today's top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two- credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

AICPA's Antifraud and Corporate Responsibility Resource Center

The AICPA's Antifraud and Corporate Responsibility Resource Center (www.aicpa.org/antifraud/) allows you to select optional ways to learn about fraud. The Center spotlights the new Web-based fraud and ethics case studies and commentaries recently issued; the AICPA antifraud Webcast series; the interactive CPA course Fraud and the CPA, and a competency model that allows you to assess your overall skills and proficiencies as they relate to fraud prevention, detection, and investigation, among other topics. In addition, the site offers press releases and newsworthy items on other AICPA courses related to prevention and detection and an overview of the AICPA Antifraud and Corporate Responsibility Program.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Webcasts

When planning your engagements, you can join the many practitioners who have participated in AICPA Webcasts. Webcasts are an exceptional way to stay current on today's professional issues. Led by recognized experts, Webcasts provide complete briefings on a variety of pertinent practice topics. During a two-hour live Webcast, participants have the opportunity to e-mail and ask questions of expert panelists.

Additionally, past archived Webcasts are available in CD format and can be accessed at https://www.cpa2biz.com/CS2000/Products/Product+Detail.htm?cs_id={97573D6D-56D1-426C-84E1-56DBF55E42DE}&cs_catalog=CPA2Biz&cs_category=accounting_auditing. CPE credit is earned for both live and CD version participation.

AICPA Online and CPA2Biz

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the *Professional Standards*, and CPE courses. To learn more, visit www.aicpa.org.

Additional Information Sources

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed at the end of this Alert.

This Audit Risk Alert replaces the *Insurance Industry Developments—2002/2003* Audit Risk Alert. The *Insurance Industry Developments Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to jgould@aicpa.org, or write to:

Julie Gould, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

INFORMATION SOURCES

Organization	*General Information*	*Fax Services*	*Internet*
American Institute of Certified Public Accountants (AICPA)	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24-Hour Fax Hotline* (201) 938-3787	www.aicpa.org www.cpa2biz.com
Financial Accounting Standards Board (FASB)	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org
Financial Crimes Enforcement Network (FinCEN)	2070 Chain Bridge Road Vienna, VA 22182 (703) 905-3770	(703) 905-3885	www.ustreas.gov/fincen
National Association of Insurance Commissioners (NAIC)	2301 McGee Street Suite 800 Kansas City, MO 64108-2662 (816) 842-3600	(816) 783-8175	www.naic.org

Public Company Accounting Oversight Board (PCAOB)	1666 K Street N.W. Washington, DC 20006 (202) 207-9100	(202) 862-8430	www.pcaobus.org
U.S. General Accounting Office (GAO)	Superintendent of Documents U.S. Government Printing Office Washington, D.C. 20401-0001 (202) 512-1800	*Information Line* (202) 512-2250	www.gpo.gov
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